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C O N F I D E N T I A L SECTION 01 OF 03 YEREVAN 001014

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SUBJECT: AMBASSADOR'S INTRODUCTORY MEETING WITH CENTRAL  
BANK CHAIRMAN

Classified By: Ambassador Marie L. Yovanovitch. Reasons 1.4 (b/d)

SUMMARY

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¶1. (C) In their introductory meeting December 8, Central Bank of Armenia (CBA) Chairman Arthur Javadyan stressed to the Ambassador the high priority the CBA places on maintaining monetary stability and preventing panic among Armenian depositors. He insisted that Armenia's banking system is in sound condition, due to conservative banking practices and low levels of debt in the Armenian economy. Javadyan defended the CBA's revocation of Western Union's license over its withdrawal from Nagorno-Karabakh, which is reported septel. End Summary.

MONETARY STABILITY IS KEY

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¶2. (C) During their introductory meeting December 9, CBA Chairman Arthur Javadyan told Ambassador that he is not concerned about the Armenian banking sector, as it is stable, liquid and well-capitalized, with liquidity and capital-adequacy ratios well within normal ranges and higher than in many western banks. While this is not necessarily good for generating financial returns, most banks are in a good position to meet cash demands of their depositors, if necessary.

¶3. (C) Asked about CBA intervention in the foreign exchange markets to support the Dram--the CBA spent USD 100 million in October and November doing so--Javadyan confirmed the CBA's support for floating exchange rates, but said the CBA is trying to smoothe fluctuations. The CBA's target is not a particular exchange rate but accumulated foreign-currency reserves equal to the value of three months of imports; the reserve balance is now equal to 3.2 months of imports. He noted that while the CBA has spent USD 170 million supporting the Dram during 2008, just two weeks ago the CBA purchased USD to maintain stability. Javadyan acknowledged that there is not necessarily an economic rationale for tying financial stability to the exchange rate, but that a volatile exchange rate will likely generate panic among the public and provoke a run on deposits.

DEPOSITS AND LOANS ARE UP

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¶4. (C) Javadyan noted that in the first part of December, bank deposits, especially from households (as opposed to businesses with seasonally-based transactions) have been increasing, suggesting favorable trends for household savings and confidence in the banking system. While deposits fell slightly in November, that was largely the result of some depositors needing to meet cash needs rather than a reflection of panic. Lending in October and November also increased, though terms are becoming more stringent, especially for real estate transactions, where banks have in the past generally assumed prices would only increase. Personal loans and those for SMEs are on the increase, as

well, and for the first ten months of 2008, year-to-year lending increased 58 percent over 2007, comparable to the increase during the same period in the prior year.

15. (C) Decreased activity is coming largely from the real sector rather than the financial sector, with the mining and chemical industries particularly affected. (NOTE: In a separate conversation December 9, the British CEO of HSBC Bank Armenia commented that the stock of bank deposits in the Armenian banking sector had declined three percent in October-November, in a seeming show of no-confidence. He also said that HSBC's lending portfolio had reached record highs during the period, because most other banks in Armenian had dramatically curtailed lending, leaving the field to HSBC. However, as a result, HSBC will soon run short of available capital to lend, with flat deposits lagging well behind the spike in loan applications. END NOTE)

#### CONCERN ABOUT RUSSIA

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16. (C) Javadyan confirmed that Armenia remains highly vulnerable to developments in the Russian economy. In addition to concern about declines in employment leading to a major reduction in remittances, Russian consumers carry much higher debt loads than Armenians, so a high level of credit defaults could further devastate the banking system, which already faced closure of hundreds of institutions. (According to Javadyan, in late November the Vice Governor of Russia's Central Bank announced plans to close 400 banks, and subsequently increased the figure to 900. Also, Russian Prime Minister Putin met recently with bankers and businesspersons, and said that 200 banks should be enough for

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Russia). The CBA is concerned that while Armenian banks are in good condition, failure of Russian banks could create a panic among Armenians that could imperil healthy Armenian institutions. Many Armenia workers in Russia also have accounts in Russian banks.

17. (C) While the CBA has been projecting zero growth of remittances in 2009, Javadyan indicated that it is still difficult to make a realistic projection. One factor is that the Russian government is considering potential stimulus programs, with one possibility a proposal to subsidize completion of buildings or roads already more than 50 percent finished. Given the number of Armenians working in the Russian construction sector, such an initiative could blunt the job loss for Armenians and help keep remittances flowing.

#### DRAM-DENOMINATED MORTGAGES

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18. (C) Javadyan said that the CBA is still considering the possibility of amending regulations under the Law on Currencies to require that all mortgage lending be done in AMD, as is already required for other types of loans. While some financial institutions that receive funds from abroad are concerned about the impact of such a regulation on their business, Javadyan indicated that having a significant part of the economy denominated in other currencies can lead to problems with monetary policy and undermine the CBA's goal of ensuring monetary stability. He noted that when Moody's and Fitch rated Armenia last year, both cited concerns about creeping dollarization or currency substitution. (Note: Our contacts at Fitch told EconOff that they do not identify specific policy actions as ratings triggers. However, they confirm that a high level of dollarization can be problematic for sovereign credit, as it exposes the economy to sharp exchange-rate movements. End Note).

19. Javadyan noted that only last year did AMD-denominated deposits exceed USD-denominated deposits (as of October 31, foreign currencies comprised 43 percent of bank deposits and 39 percent of outstanding loans). He stressed the importance of protecting consumers from long-term foreign exchange risks if they borrow in currencies other than AMD, particularly

over a 15-year mortgage term. He insisted, however, that the proposal is only being circulated at present, with a decision still several months away. With inflation not a serious concern at present, the CBA just this week reduced the "repo" (overnight lending) rate by 50 basis points, to 7.25 percent. Javadyan hopes that the rate will soon be reduced to 6.5 percent, if the threat of inflation remains low. This rate remains the lowest in the CIS region.

#### LOSSES FROM RUSSIA-GEORGIA CONFLICT

¶10. (C) Javadyan reiterated the GOAM's estimates that losses to the Armenian economy--both direct and indirect--from the August conflict between Russia and Georgia were close to USD 700 million. He noted that the estimate--first undertaken by the Ministry of Finance and later reviewed and modified slightly by the CBA--employed the same methodology as the Georgian government had used its own estimates. Javadyan noted that the global financial crisis began to take effect only in late September--when global commodity prices began to fall--and there is little likelihood that the GOAM is conflating the effects of the two crises in estimating its economic losses. (Comment: We are less certain that USD 700 million is an accurate figure and IMF calculations do not support this amount of losses in Armenia. End Comment).

#### ARMENIA'S FISCAL STIMULUS

¶11. (SBU) Javadyan outlined a number of projects the GOAM plans to undertake in order to spur economic activity. These include completion of a long-discussed (since 2000) north-south railroad linking Russia to Iran (through Georgia and Armenia); replacement of the Armenian Nuclear Power Plant (ANPP) and construction of over 4,000 housing units in the areas most severely damaged by the 1988 earthquake, including Gyumri, Spitak and some villages. If there is no increase in commodity prices in the next 6-7 months, the GOAM will look to undertake other projects, as well. (Comment: All of these are long-term projects that are unlikely--particularly in the case of the nuclear power plant--to be initiated within the next several months. While they will also doubtless be of considerable economic benefit to Armenia in the future, they seem to be of little value in the short run. End Comment).

#### MONEY-LAUNDERING PROSECUTIONS

¶12. (C) Ambassador praised the cooperation of the Financial

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Monitoring Center (FMC) with Embassy staff, though expressed regret that there have not yet been any money-laundering prosecutions initiated. Javadyan said a recent case had in fact been launched, which we are still attempting to verify.

#### COMMENT

¶13. (C) Javadyan's assessment of the economic situation seems largely on-target and the CBA has to-date engaged in prudent management of the economy and of the financial institutions under its jurisdiction. The CBA--under both Javadyan and his predecessor, now-PM Tigran Sargsian--has a reputation as a competent, serious body. We nevertheless believe that the CBA is painting a more positive picture of the road ahead than is likely warranted. End Comment.  
YOVANOVITCH